What To Do Today with the New Partnership (and LLC) Audit Rules

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1. Who is Subject to New Partnership Audit Rules?

   a. The new rules, created by the Bipartisan Budget Act of 2015 (the “Act”), apply to tax returns filed for partnership taxable years beginning after December 31, 2017 (the “New Partnership Audit Rules”). The new rules are mandatory for all partnerships unless certain eligibility requirements are met and a valid election out has been made for a taxable year [Section 6221(b)].

      i. It is possible for partnerships that are selected for audit for a tax year beginning before 2018 to early adopt these new rules by making an election with the IRS. For procedures on electing in for pre-2018 tax years see Early-Election Procedures below.

   b. If a partnership elects out of the new rules, the partnership is subject to the assessment and collection rules that apply to small partnerships that are not subject to the current TEFRA rules.

      i. Basics: The IRS may audit the partnership at the partnership level. However, the IRS must focus on each partner for purposes of extension of statute of limitations, settlements, and assessments.

         1. Each partner must enter a separate agreement to extend the statute of limitations for assessment; the partnership cannot bind the partners.

         2. The partnership cannot settle partnership items on behalf of any of its partners.

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3. The IRS must issue statutory notices of deficiency to each partner within the partner's limitation period under Section 6501. The partner would have a right to challenge a proposed assessment in Tax Court. This may result in multiple Tax Court cases challenging exactly the same partnership item adjustment.

c. Election Out Procedure (Section 6221(b))

i. General Requirements. In order to elect out of the new rules, the partnership must satisfy the following two criteria:

1. Each of the its partners is an individual, a deceased partner’s estate, a C corporation, an S Corporation, or a foreign entity that would be treated as a C Corporation if were domestic (“Partner Eligibility Requirement”); and

2. The partnership is required to furnish 100 or fewer Schedule K-1s under Section 6031(b) for its partners for that tax year (the “100-or-Fewer Requirement”).

ii. Specifics: Partner Eligibility Requirement

1. Each partnership should consider the initial question regarding due diligence requirements for the partnership to determine if this test is met. For example, further clarification is needed regarding whether the partnership can rely on legal records concerning who owns the partnership interests or whether the partnership has to conduct due diligence on each partner.

2. The presence of a real estate investment trust or a regulated investment company as a partner does not disqualify the partnership from proceeding with an election out as both are considered corporations. This is clarified in the JCT summary.

3. A foreign entity that is an association that is taxable as a corporation for federal income tax purposes is an eligible partner. While not directly addressed, it is presumed that foreign entities that have elected to be treated as a C Corporation or a foreign entity that is a “Per Se” corporation under the entity classification rules of Section 7701 and Treasury Regulations 301.7701-2 are permitted partners for purposes of this requirement.

4. Until further guidance is issued, it appears that a partnership does not have to look through an S Corporation when examining the Partner Eligibility Requirements (but must look through when examining the 100-or-Fewer Requirement, discussed below).
iii. Specifics: 100-or-Fewer Requirement

1. This requirement is based on the number of Schedules K-1 that are required to be furnished, rather than the number actually furnished, during the tax year.

   BEWARE – if there are partnership-interest transfers within a tax year that require the issuance of Schedules K-1 to two different partners for the same interest, both the former and current partner is counted for purposes of this test.

2. For partnerships with certain types of pass through partners (S Corporations, disregarded entities, trusts, etc.), the new rules contemplate counting the number of Schedules K-1 the underlying partner issues to its owners. Further, the JCT report notes that IRS guidance will determine whether certain types of partners, such as a trust or a disregarded entity, satisfy the Partnership Eligibility Requirements.

   EXAMPLE. A partnership has as partners 45 individuals, as well as one S Corporation. If the S Corporation has 60 shareholders (all of whom are individuals), then for purposes of the 100-or-Fewer Requirements, this partnership is treated as required to furnish 106 Schedules K-1 (that is, the 49 individual partners plus the S corporation plus the 60 S Corporation shareholders).

iv. Election

1. Who makes the election? The partnership makes the election and the new rules do not provide for a mechanism for a partner to participate in the decision to make the election out or not. Therefore, partnerships should consider modifying partnership agreements to address the process for each partnership to determine whether to make an election or not.

2. Timing.

   a. An election must be made with a timely filed return for that tax year and is only valid for that tax year.

   b. A partnership cannot wait until the IRS decides to audit the tax return to elect out. Therefore, partnership should
consider the election-out process before filing the partnership tax return.

c. Given that an election is only effective for one taxable year, it appears that the partnership can make an election out for some years and not for others.

3. Requirements.

   a. The election made with the IRS must include the name and taxpayer identification number of each partner of the partnership in the manner prescribed by the IRS (further guidance is needed from the IRS).

   b. The partnership must also provide notice to each partner of the election out. Further guidance is needed from the IRS regarding the notification process.

   c. If the partnership has an S Corporation as a partner, the election must also include the name and taxpayer identification number for each person to whom the S Corporation is required to furnish a Schedule K-1 under Section 6037(b).

2. Basic Mechanics of Partnership Audits


      i. The IRS initiates a partnership examination by issuing a notice of administrative proceeding to the partnership or its representative;

         Once a notice of administrative proceeding for a tax year has been mailed, the partnership cannot file an administrative adjustment request (AAR) for any partnership items for that tax year.

      ii. If, as a result of the partnership audit, the IRS determines that the partnership overstated income or gain (or understated losses and deductions), *i.e.*, no additional tax due, in the reviewed years, the partnership must adjust its non-separately stated income or loss for the year the adjustment is made (with the reduced income or increased deductions generally benefitting the adjustment-year partners, not the reviewed-year partners);

      iii. On the other hand, if the IRS determines that the partnership understated its income or gain (or overstated losses or deductions) in the reviewed year, then the IRS determines the amount of tax required to be paid – the
imputed underpayment – and mails the partnership a notice of proposed partnership adjustment;

iv. The partnership has 270 days after the date it receives the notice to submit specified information that can be used to reduce the amount of the imputed underpayment;

v. After the IRS reviews this information, it will issue a notice of final partnership adjustment;

vi. Under the New Partnership Audit Rules, the partnership has 45 days to decide whether to make a Push Out Election (discussed below), which results in the adjustments being pushed out to the partners of the reviewed (audited) year instead of having a partnership-level tax paid; and

vii. Assuming no “Push Out Election” was made, the partnership has 90 days after receipt of the final partnership adjustment to file a petition for a readjustment with the U.S. Tax Court, the Court of Federal Claims, or the U.S. District Court for a district in which the partnership has its principal place of business.

Note. The Court has the ability to determine the partnership items, but also the proper allocation of those adjusted items among the partners and the applicability of penalties and interest.

d. Application of Subchapter K Rules to Partnership-Level Payment [assuming no Push Out Election].

i. If an imputed underpayment is paid at the partnership level, the partnership should:

1. Reduce each partner’s basis in its partnership interest by its share of the payment under Section 705(a)(2)(B) for the nondeductible payment; and

2. Reduce the partnership’s adjusted basis in its assets by the same amount.

3. It is unclear whether the partners should also be allocated their share of the understatement of income that underlies the imputed underpayment paid by the partnership. Without an upward adjustment, however, there is the possibility for double tax.

4. Similar issues arise regarding the impact of the disallowance of deductions. For example, if the IRS disallows a depreciation deduction for an assets, should the partnership increase its basis in
the asset and should the partners increase their basis in the partnership? Further guidance is needed.

5. Current partners may bear the burden of an underpayment related to a year in which they were not a partner.

c. If the partnership chooses not to make a Push Out Election and pay the tax at the partnership level, it may require its partners (current or former) to contribute capital to make the payment (the “Short Fall Contribution”).

i. For current partners that make a Short Fall Contribution, it seems logical that it would be considered a contribution to the partnership, with a corresponding increase in the partner’s outside basis and capital accounts. Of course, the increases will be offset by decreases for that partner’s share of nondeductible partnership payment.

ii. For former partners, the treatment of the Short Fall Contribution is unclear. As a partnership agreement may require that former partners (from the audited year) contribute to the partnership to cover for any tax deficiency based on the year that such partner had an interest in the partnership, additional guidance is needed for partnerships to determine how to treat such contribution. For example, the partnership could:

1. Treat former partner’s contributions like current partner, i.e., offsetting adjustments. Unusual result of a K-1 potentially being issued with no share of current year income or deduction.

2. Treat the former partner’s contribution as a payment of a contractual liability owed to the partnership (as opposed to a contribution). This construct would be more likely if the partnership agreement provided that such payments by the partnership are made on behalf of the partners and reimbursement was required.

3. Presumably, future guidance would confirm that the payment by the partner is not income to the partnership.

d. During the 270 days that the partnership has between the time it receives the initial notice to when the IRS may issue the final notice, the partnership has the ability to provide information to the IRS to permit the IRS to modify the amount of the partnership’s imputed underpayment in the following situations:

i. The partners include tax-exempt entities that would not have been subject to tax on their shares of understated income or gain;
ii. The adjustment concerns income and gain allocable to C Corporation partners or capital gains and qualified dividends allocable to individuals and S Corporations;

iii. The partnership is a publicly traded partnership and there is a net decrease in specific passive activity losses allocable to specific partners; or

iv. The reviewed-year partners file amended returns and pay additional tax due for understated income or gain.

e. Reallocations Among Partners (Section 6225(a)). The IRS can make adjustments to the allocations of partnership items among the partners in the partnership.

i. If a reallocation occurs, the amount of the partnership’s imputed underpayment is increased to reflect the component of the reallocation that increases income to one partner, but is not decreased to take into account the component that decreases income to another partner, unless all the partners affected by the reallocation file amended returns for the reviewed year and pay any associated tax due.


a. General. For partnerships that have not elected out (as discussed above) of the new rules, additional considerations must be made if the IRS determines that there is a partnership imputed underpayment for an audited/reviewed tax year. The partnership must decide whether to:

i. Pay the imputed underpayment at the partnership level under the general rules for underpayment; or

ii. Push out adjustments to reviewed-year partners (which by definition can include former partners) under the alternative method, described below (partnership assessment and payment rules would not apply).

   1. The imputed underpayment would be pushed out to a reviewed-year partner in the reviewed year rather than the adjustment year. Thus, those partners will include these adjustments in the years in which they receive the reports (not the year which was under audit) of the adjustments in computing their tax liabilities.

   2. Reviewed year partners would also be liable for any penalties which are determined at the partnership level.

      a. It does not appear that the reviewed-year partners are jointly and severally liable for the penalties.
b. It is unclear how each partner’s share of the penalties will be determined and to what extent a partner might be able to raise defenses based on its own reasonable cause or lack of negligence.

c. It is also unclear how tax exempt partners will be treated with respect to the liability for penalties considering that such partner is not liable for its share of the underreported tax.

3. Deficiency interest runs from the reviewed year, and is calculated as follows:

   a. Interest is determined at the partner level,

   b. From the due date of the return for the taxable year to which the increase is attributable, and

   c. At the underpayment rate under Section 6621(a)(2), determined by substituting “5 percentage points” for “3 percentage points” in subparagraph (B).

   Note. The extra two percentage points is considered a toll charge for use of the alternative method.

b. How to make a Push Out Election.

   i. Partnership must file an election with the IRS no later than 45 days after the date of the notice of the notice of final partnership adjustment.

      1. Once an election is made, it can only be revoked with the consent of the IRS.

      2. The election can be made regardless of whether the partnership files a petition for judicial review of the final partnership adjustment notice, but the election is not implemented until the final court decision.

   ii. Partnership must furnish specific statements to the reviewed-year partners and the IRS.

      Note. Without late election relief, the partnership faces significant time demands to send out partner statements within the 45-day time period to be eligible to make this election.
c. How are the adjustment amounts calculated?

i. The reviewed-year partner increases his tax imposed under Chapter 1 of the Internal Revenue Code for the tax year that includes the date the statement is furnished (the current tax year) to reflect the sum of:

1. For the tax year of the partner that includes the end of the reviewed year, the amount by which the tax imposed under Chapter 1 would increase if the partner’s share of the adjustments were taken into account for such year, plus

2. For a tax year after the tax year described above and before the current tax year, the amount by which the tax imposed under Chapter 1 would increase because of tax attributes that would have been affected by specific adjustments to tax attributes.

d. Reviewed-Year Partners’ Inability to Dispute Partnership Adjustments

i. The partnership representative is the sole person who can act on behalf of the partnership in a partnership audit. Thus, the partnership representative binds both the partnership and the partners in the audit and controversy. [Section 6224(c)(1)] The partnership representative has the power to settle the audit or challenge judicially. The partnership representative will not need to file a Form 2848, Power of Attorney and Declaration of Representative.

ii. Reviewed-year partners are not permitted to challenge the substantive merits of the adjustments contained in the final partnership adjustment. This concept was likely put into place to avoid multiple litigations of the substantive issues.

iii. It also appears that a reviewed-year partner does not have the ability to establish that it was not a partner in the reviewed year or that its share of the adjustments is incorrect.

iv. It is also not clear whether a reviewed-year partner that pays the allocated adjustment can then seek a refund through the traditional refund litigation procedures.

4. Early-Election Procedures

a. Starting in 2018, the IRS will generally be allowed to assess partnership audit adjustments at the partnership level and collect the tax from the partnership. Now, new procedures allow taxpayers to elect to apply these new entity-audit rules early (the “Early Opt-In Election”).
b. General Overview

i. The Act generally permits a partnership to elect to have the New Partnership Audit Rules apply to partnership returns filed for partnership taxable years beginning after November 2, 2015, but before January 1, 2018 ("Eligible Tax Year").

ii. To make an Early Opt-In Election, the partnership must first have received written notice from the IRS that a partnership return for an Eligible Tax Year has been selected for examination. The regulations provide that an Early Opt-In Election must be made within 30 days of the date of notification to the partnership.

iii. The Early Opt-In Election is made by providing a written statement, dated and signed by the tax matters partner or other authorized person, to the IRS. The statement must include a heading of “Election under Section 1101(g)(4),” must be signed under penalties of perjury by the tax matters partner, as defined under Code Section 6231(a)(7) of the TEFRA partnership procedures, and must include the contact information of the signatory for the partnership.

iv. The Early Opt-In Election must also include the following representations that the partnership (i) is not insolvent and does not reasonably anticipate becoming insolvent; (ii) is not currently and does not reasonably anticipate becoming subject to a bankruptcy petition; and (iii) reasonably anticipates having sufficient assets to pay the potential imputed underpayment liability during the partnership audit. Moreover, the statement must also include language designating the partnership representative, as defined in section 6223 as amended by the New Partnership Audit Rules, the contact information of said representative, and that the partnership is electing to apply the New Partnership Audit Rules for the partnership return under audit.

c. Exceptions to the General Rule

i. An exception is provided to the general rule regarding the Early Opt-In Election. A partnership may make an Early Opt-In Election without first having received an examination notice from the IRS, if the partnership will file an administrative adjustment request ("AAR") under the Act for an Eligible Tax Year. In no case, however, may a partnership make an Early Opt-In Election under this exception earlier than January 1, 2018.

ii. The preamble to the regulations indicates that the IRS intends to issue guidance regarding AARs under section 6227 as amended by the Act before January 1, 2018. Once made, all aspects of the New Partnership Audit Rules apply to the partnership return filed for the Eligible Tax Year.
subject to the Early Opt-In Election and may not be revoked without the IRS’s consent. Therefore, a partnership making such an election must ensure all changes of the New Partnership Audit Rules are, or will be, implemented.

d. Revocation & Inapplicability of the Early Opt-In Election

i. Early Opt-In Elections will be invalid and revoked if the election is not made in accordance with the regulations or frustrates the purpose of the Act, i.e., to simplify the IRS’s ability to collect revenue through taxes, penalties, and interest on partnership tax item adjustments. Likewise, if a tax matters partner has previously filed for an AAR for the partnership under the TEFRA rules or an amended partnership return has been filed for the partnership for the year under audit, the Early Opt-In Election is unavailable. Finally, relief under Treas. Reg. §301.9100-3 is unavailable to partnerships wishing to request an extension of time to make the Early Opt-In Election.

ii. Given the uncertainty in the New Partnership Audit Rules and absence of final regulations, it is unlikely a partnership would find it advantageous to make an Early Opt-In Election to be taxed at the partnership level. The IRS expects to issue more thorough guidance prior to 2018, which should provide much-needed clarification. In the interim, the best course of action would be to review existing partnership and LLC agreements now in preparation of the impending New Partnership Audit Rules.

5. Partnership Agreement Drafting

a. New Partnerships vs. Existing Partnerships

i. All new partnership agreements should address the basic contractual items such as is the identity of the Partnership Representative (“PR”), what powers does the PR have, what information should be given to the PR and what information should be shared with the partners, and how does the partnership allocate any entity-level taxes among the partners.

ii. Existing partnership agreements should be amended immediately, but as a practical matter may be done when there is otherwise a change to the partnership necessitating an amendment to the agreement. A general process of amending any remaining agreements should be done before the January 1, 2018 effective date, at which time hopefully there will be more guidance to address open legal questions. Agreements can also contain language obligating the partners to amend the agreement upon issuance of guidance.

iii. Sample Language:
1. To the extent necessary, the Members agree to negotiate in good faith to amend the terms of this Agreement in a manner that, as closely as possible, preserves the rights and responsibilities of the Members, including with respect to the rights and responsibilities of the Tax Matters Member and the payment of tax liabilities, as such rights and responsibilities are reflected in this Agreement, to reflect any Treasury Regulations or upon further [New Partnership Audit Rules] authorities being enacted, promulgated or issued after the Effective Date.

b. Contractual Issues

i. Identity of the Partnership Representative

1. There is no automatic conversion of the person designated as the TMP to convert to the PR, although in most cases it will be the same person.

2. If a PR is not designated, the IRS may select “any person” as the PR.

3. The PR need not be an individual, it can be a partner (including an entity partner), or any “person,” as long as they have a “substantial presence” (not defined in the statutory scheme) in the U.S.

4. The PR is a very powerful role, much more than the TMP, and thus the partnership may want to reconsider who is the PR vs. the TMP, or at least impose more contractual restrictions on the PR’s authority.

5. Because the PR need not be a partner, consider whether a key employee should be the PR. Because the PR needs to have a “substantial presence” in the U.S., it is possible that if both partners are non-U.S., a non-partner U.S. person may be required to satisfy this substantial presence test. An agreement should also consider procedures for how to replace a PR.

6. Sample Language

a. [name of designated TMP] shall be designated on the Company’s annual federal information tax return as (i) the initial “tax matters partner” of the Company for purposes of Section 6231(a)(7) of the Code and shall have all the rights and responsibilities of that position described in Section 6222 through Section 6232 of the Code, as in effect prior to their repeal by the Revised Partnership Audit
Procedures, and (ii) the initial “partnership representative” for purposes of Section 6223 and Section 6231 of the Code, as amended by the Revised Partnership Audit Procedures (the designated roles in clauses (i) and (ii) above shall collectively be referred to herein as the “Tax Matters Member”);

b. Resignation. The Tax Matters Member [partnership representative] may resign at any time. If [name of designated TMP or partnership representative] ceases to be the Tax Matters Member [partnership representative] for any reason, the [Board of Managers] shall appoint a new Tax Matters Member [partnership representative].

ii. Restricting Authority of PR

1. Because the PR has much more authority than under TEFRA, consider restricting the PRs authority by contract.

2. Current agreements commonly require partner approval for (1) settlements, (2) choosing a court to litigate (i.e., Tax Court vs. paying the tax and going to a refund jurisdiction), and (3) extending the statute of limitations. Consider expanding on these common restrictions to also (1) require that the PR consider input from partners on material IRS correspondence, (2) allow partner input or pre-agreement regarding all audit-related elections/decisions such as AAR decisions, and (3) require partner consent on audit elections such as election out of the new audit rules or an election to “push out” the audit adjustment.

3. Sample Language

a. In the event of an income tax audit of any tax return, including administrative settlement and judicial review, the [partnership representative] shall be authorized to act for the Company subject, however, to the [reasonable consent of the Members] as to any extensions, filings, elections, agreements, settlements or any other material action as to any such matter.

b. The [partnership representative] shall not take any action in its capacity as tax matters partner [partnership representative, other than purely ministerial actions, without the prior reasonable consent of the [_____] Member and shall not bind the [_____] Member to any extensions, settlements, or material elections for any federal, state, or
local tax purposes without [___] Member's prior written consent, such consent not to be unreasonably withheld or delayed.

iii. Giving Information to the Partners

1. Because there is no longer the concept of a “notice partner,” absent a contractual requirement, the partners may not even find out about an audit until the final audit adjustment.

2. Contractual provisions can provide that a partner must be notified of the beginning of an audit and certain material events, such as a proposed audit adjustment.

3. Sample Language

   a. Upon receipt of notice from the Internal Revenue Service (the “IRS”) of the beginning of an administrative proceeding with respect to the Company, the Tax Matters Member [partnership representative] shall inform each Member. The Tax Matters Member [partnership representative] shall give the Members prompt notice of any inquiry or other communication received from the IRS or other applicable tax authority regarding the tax treatment of the Company or the Members (as such), and shall, to the extent possible, give the Members prior notice of and a reasonable opportunity to review and comment upon any written communication the Tax Matters Member [partnership representative] intends to make to any such taxing authority in connection with any examination, audit or other inquiry involving the Company.

iv. Requiring Partner Cooperation Including Obtaining Required Partner Information

1. The PR will need certain information from the partners in order to elect out of the new rules, to reduce the partnership-level tax assessment for tax-exempt or reduced rate partners, or to push adjustments through to the partners. The PR needs the ability to require partners to provide this information.

2. Samples of language for information sharing between partners and partnership:

   a. The Members agree to cooperate in good faith to timely provide information reasonably requested by the Tax
Matters Member [partnership representative] as needed to comply with the Revised Partnership Audit Procedures (the "Revised Audit Rules"), including without limitation to make (and take full advantage of) any elections available to the Company under the Revised Audit Rules.

b. Each Member shall provide to the Company and the Company shall provide to the Members (i) such assistance as may be reasonably requested by such Member or the Company in connection with the preparation of any tax return, any audit or any claim of refund or credit in respect of taxes and (ii) any records or other information relevant to such tax returns, audits or claims, in each case relating to the business of the Company.

v. Sharing Partnership-Level Assessments Among the Partners

1. The concept of partnership-level assessments is new and will not be addressed under existing contractual provisions. The assessment is akin to a withholding tax, which nearly all partnerships address through treating the withholding tax as an advance on the distributions otherwise distributable to that partner and, to the extent of a shortfall, by allowing the partnership to request reimbursement (often with an interest charge).

2. The general withholding language can be readily modified to address the entity-level assessments, but the partners should consider whether the partnership should have the ability to request partner reimbursement before the tax is due, as opposed to withholding language which typically involves partner reimbursement only after the partnership pays the withholding tax.

3. Sample Language

a. Any deficiency for taxes imposed on any Member (including penalties, additions to tax or interest imposed with respect to such taxes) will be paid by such Member and if required to be paid (and actually paid) by the Company, will be recoverable from such Member as provided in Section [the withholding paragraph].

b. To the extent that the Company is assessed amounts under Section 6221(a), the current or former Member(s) to which this assessment relates shall pay to the Company such Member's share of the assessed amounts, including such Member's share of any additional accrued interest
assessed against the Company relating to such Member’s share of the assessment, upon thirty (30) days of written notice from the Tax Matters Member requesting the payment. At the reasonable discretion of the Tax Matters Member, with respect to current Members, the Company may alternatively allow some or all of a Member’s obligation pursuant to the preceding sentence to be applied to and reduce the next distribution(s) otherwise payable to such Member under this Agreement.

vi. Granting Authority to Partnership Representative. Although the tax statute automatically gives broad authority to the PR, many agreements clarify such authority by contract so that it is clear that the parties have agreed to such powers.

1. Sample Language:

   a. The authority of the Tax Matters Partner and the Partnership Representative, as applicable, shall include the authority to represent the Company before taxing authorities and courts in tax matters affecting the Company and the Members in their capacity as such and, with respect to the Partnership Representative, the authority to make the election under Section 6226 [of the BBA Rules] in connection with any audit.

   b. Tax Examinations and Audits. The Tax Matters Member[partnership representative] is authorized and required to represent the Company (at the Company’s expense) in connection with all examinations of the Company’s affairs by Taxing Authorities, including resulting administrative and judicial proceedings, and to expend Company funds for professional services and costs associated therewith. Each Member agrees that any action taken by the Tax Matters Member in connection with audits of the Company shall be binding upon such Members and that such Member shall not independently act with respect to tax audits or tax litigation affecting the Company.

vii. Allocating Partnership-Level Tax Among the Partners

1. The assessment of tax at the partnership level creates the practical question of how to share the expense among the partners. For example, if the partnership-level tax is reduced because one of the partner’s is tax-exempt, such tax-exempt partner would want the benefit of that tax reduction. Agreements should provide for
flexibility in exactly how to divide this burden as the current state of the law does not provide black-line rules for this determination.

2. Sample Language

a. For the avoidance of doubt, any taxes, penalties, and interest payable under the Revised Partnership Audit Procedures by the Company or any fiscally transparent entity in which the Company owns an interest shall be treated as specifically attributable to the Members, and the Tax Matters Member [partnership representative] shall use commercially reasonable efforts to allocate the burden of (or any diminution in distributable proceeds resulting from) any such taxes, penalties or interest to those Members to whom such amounts are specifically attributable (whether as a result of their status, actions, inactions or otherwise), as determined in Good Faith by the Tax Matters Member.

b. The Company shall make any payments of assessed amounts under Section 6221 of the [Revised Partnership Audit Procedures] and shall allocate any such assessment among the current or former Members of the Company for the “reviewed year” to which the assessment relates in a manner that reflects the current or former Members’ respective interests in the Company for that reviewed year based on such Member’s share of such assessment as would have occurred if the Company had amended the tax returns for such reviewed year and such Member incurred the assessment directly (using the tax rates applicable to the Company under Section 6225(b)).

c. If the Company is directly or indirectly subject to any tax liabilities (including interest and penalties assessed thereon) under the [Revised Partnership Audit Procedures] (and any similar state and local authority), the Board of Directors shall allocate among the Members any tax liability (including interest and penalties assessed thereon) imposed under the [Revised Partnership Audit Procedures] in a manner it determines to be fair and equitable by reducing amounts otherwise distributable to Members, taking into account any modifications attributable to a Member pursuant to Section 6225(c) of the [Revised Partnership Audit Procedures] (if applicable) and any similar state and local authority. Any tax liabilities so
allocated shall be treated as subject to the provisions of Section ____ [withholding tax provisions].

d. To each Member's Capital Account there will be debited...any items in the nature of expenses or losses (including such items that cannot be capitalized or deducted in computing taxable income, which for the avoidance of doubt, shall include any payment by the Company of an Imputed Underpayment or other nondeductible penalties and/or interest under [Revised Partnership Audit Procedures]).

viii. Survival. Because a partnership audit can continue well beyond the termination of partnership, many agreements will clarify that the audit language “survives” the partnership. A sample survival provision is: Survival. This Section ____ shall survive the termination of this Agreement.

ix. Elections In, Out, and In-Between

1. A partnership may decide to mandate that, if eligible, it will elect out of the new audit rules. Since this election is required every year, the decision should include the years it should be in effect. Because certain types of partners cause a partnership to not be eligible for this election, consider combining such a restriction with a transfer restriction.

2. Another critical election is whether to “push out” the adjustments to the partners under Section 6226. Because of the 2% higher interest charge and the uncertainty whether this push out can go beyond the first tier partnership, this is a decision that is probably best decided on a case by case basis.

3. A third election is whether to elect into the rules before the January 1, 2018 mandatory effective date. Because of the lack of certainty under the rules and the entity-level taxes that create business concerns, it is unlikely than there will be many of such elections.

4. An in-between option is a Section 6227 administrative adjustment request, which is essentially an amended return, but must be done before the audit begins.

6. Conclusion

a. The new partnership audit rules have dramatically changed the landscape of partnership audits, but the more things change the more things stay the same in terms of the issues that need addressed. Until regulations address fundamental
questions, perhaps the best one can do is maintain flexibility.

b. Perhaps one of the most practical questions after drafting partnership agreement language will be how people handle partnerships from a due diligence standpoint when investing into an existing partnership and how that complication may affect decisions taken when returns are filed. The potential of an entity-level tax for pre-acquisition years is a novel concept and was previously limited to state and local taxes and withholding taxes, but the stakes have been raised.